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AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Business Objective 9.1

II. PROGRAM: Total Fund

III. RECOMMENDATION: Information

IV. ANALYSIS:

Background

Strategic Goal 9 seeks to achieve long-term, sustainable, risk-adjusted returns. Under this Goal, Business Objective 9.1 was developed to identify and implement new investment strategies and opportunities to enhance long-term, sustainable returns and provide the Investment Committee with a report documenting their value added and cost effectiveness.

Since the establishment of Business Objective 9.1 in September 2006, several initiatives have been developed across the entire portfolio. This agenda item identifies these new strategies and describes their value added and cost effectiveness. Each of these strategies has made a demonstrated contribution in at least one of the following areas: investment performance, staff development, cost savings, and diversification. Attachment 1 provides a matrix that outlines these contributions.

Adoption of Inflation Linked Asset Class

In December 2007, the Committee formally approved the Inflation Linked Asset Class (ILAC) as a fifth asset class with a target allocation of up to 5 percent. ILAC was created to contribute to the diversification of the overall CalPERS portfolio by generating attractive risk-adjusted rates of return while hedging against inflation and long term liabilities. ILAC comprises four programs: infrastructure, forestland, inflation-linked bonds and commodities.

By identifying and co-locating assets that share unique risk and return characteristics, staff will have the opportunity to develop investment expertise and knowledge specific to these areas. In addition, ILAC will provide access to new sources of long-term investments with inflation-linked returns that will help align CalPERS plan assets with its liabilities.

With the approval of the final investment policy in August 2008, ILAC completed the development of a framework by which CalPERS will act as a responsible steward of program assets through utilization of responsible labor and management practices and implementation of responsible environmental practices.

Real Estate Program Restructure

Over the years, the increasing size and complexity of the real estate portfolio had developed a number of challenges in the areas of staffing, monitoring, and portfolio analysis. To address these issues and to assure CalPERS continues to be the real estate “investor of choice,” the Real Estate program began a strategic review to address these issues. The development and implementation of the Real Estate Strategic Plan was the culmination of that review and over the last year several important goals outlined in the plan have been achieved.

Among the actions taken were the restructuring of the portfolio to change from Core and Non-Core structure to Core, Value-Added and Opportunistic structure; setting new target ranges for each sector of the portfolio; targeting 50% international investments over time; adopting a new, more appropriate portfolio benchmark; and increasing human and system resources as needed.

The Strategic Plan also directed staff to review the Real Estate program’s investment policy and examine current assumptions concerning the portfolio in light of global market conditions. After an extensive review involving the General Pension Consultant, the Board’s Real Estate consultant, the CalPERS legal office, the Office of Enterprise Compliance, and investment staff, the revised investment policy was brought forward to the Investment Policy Subcommittee. A second reading of the Real Estate program’s investment policy was approved by the Policy Subcommittee in December 2008, and a third reading is scheduled for April 2009.

Implementing these changes places the Real Estate program in a position to maximize investment returns over the long term. Its structure is now more aligned with market norms, diversified, and structured to allow for more staff development and cross-training with the addition of resources.

Establishment of New Internally Managed Equity Portfolios

Potential strategies for new internally managed International Small/Micro Cap and Emerging Markets were identified in February 2008. In March 2008, the Investment Committee approved the implementation of these new portfolios.

Adding these portfolios increases the opportunity for staff development by providing greater depth of experience and exposure to a variety of new perspectives. In addition, the management of these portfolios aids in the development of the tools and processes required to manage a diverse array of equity assets.

Internally managed portfolios also achieve significant cost savings. Average external management fees for these market segments average between $2.5 million to $4 million per $1 billion in capital managed. External index management fees would be lower at $250 thousand to $500 thousand per $1 billion in capital managed. Internal management will achieve cost effectiveness by saving this expense entirely.

Establishment of Emerging Manager Equity Strategies

The establishment of two emerging manager equity strategies in 2007 enabled CalPERS to expand its opportunity set within the emerging manager universe without requiring a significant increase in staff resources. By employing a fund-of-funds framework, CalPERS deploys assets more effectively and increases the fund's exposure to a large universe of new managers with unique perspectives.

The Emerging Manager Fund-of-Funds Program within our MDP II program uses two advisors to manage 24 constituent funds while the Fund of Emerging Hedge Funds Program within the RMARS program uses three advisors to manage a total of 56 constituent funds.

These programs have allowed CalPERS to develop relationships with smaller firms that would otherwise not have access to investment opportunities due to their size. In addition, the strategies provide a high level of diversification within each portfolio of funds which contributes to reduced volatility and the potential for higher returns.

Revision of the Policy for the Credit Enhancement Program

The Credit Enhancement Program (CEP) was initially approved and began operating in 2005. CEP was designed to provide credit enhancement to states and municipalities nationwide by improving credit availability and improving liquidity for debt issuance; earn fee income through a zero loss underwriting standard; and generate fees from annual commitments, up front closings, amendments and waivers.

In June 2008, the Committee approved revisions to the program that will increase the CEP total aggregate commitment amount from $5 billion to $10 billion. This change will allow the program to meet market demand and eliminate the dollar based transaction limit by moving to a percentage based limit.

Municipalities that benefit from CEP have had difficulty obtaining credit enhancement given the recent market turmoil. With the increase in the total commitment amount, CalPERS will be able to assist these municipalities by providing more liquidity options and potentially reducing their overall financing costs. In addition, the increase and the implementation of the new percentage based limit will increase revenue from the program and positively impact overall fund performance.

Internally Managed Active Currency Overlay Portfolio

The Internally Managed Active Currency Overlay Portfolio was launched in April 2007 as a pilot program designed to reduce the volatility of the returns from international equity investments while potentially profiting from the inherent inefficiencies in the currency markets.

Although initially launched as a pilot program, the success of this initiative could lead to an expansion of the program and result in a reduction of currency risk across the total fund. This reduction in risk would also be accompanied by a modest investment return that would add value over the long term.

Since inception, the Portfolio has added value with a cumulative return of 0.7% and reduced costs by maximizing internal staff competencies and foregoing the typically high expenses related to external currency managers.

Supplemental Income Plans Fund Enhancements

The Supplemental Income Plans Division implemented fund enhancements in 2008 that were designed to increase available investment options and reduce costs for plan participants. By expanding the number of CalPERS managed funds from five to nineteen, the investment expertise of CalPERS investment staff is maximized while costs are lowered and performance is increased for the benefit of participants.

These new offerings take advantage of the wide range of investment funds CalPERS manages. The CalPERS-managed funds will include actively managed funds to provide opportunities to enhance returns and passively managed (or index) funds to help keep costs low.

CalPERS-managed funds are expected to cost less than the previous externally managed funds they have replaced. In addition these funds will leverage the current expertise of the Investment Office staff while simultaneously providing staff development opportunities.

AIM Program Strategies

Over time, the increasing number of partnerships and complexity of the private equity portfolio had become a challenge in the areas of staffing, monitoring, and portfolio analysis. By completing a strategic review and developing a plan that addressed the opportunities for improvement identified in the review, the AIM Program ensured that it would continue to be the “investor of choice” in private equity.

The AIM Program’s strategic realignment was designed to more effectively manage and deploy capital in private equity. By emphasizing larger relationships with fewer partners, utilizing customized investment vehicles to deploy significant capital in attractive sectors of the market, and adding staff the AIM Program is now better situated to take advantage of opportunities in the marketplace.

The successful sale of a portfolio of funds no longer aligned with the strategic plan assisted with the reduction of the number of relationships being managed by the AIM Program. To effectively move into selected sectors, the AIM Program created several new investment vehicles focused on the following: underserved markets in California, emerging managers, venture and growth capital, clean technology, emerging markets, and healthcare industry investment. With commitments to all of these vehicles totaling more than $2 billion, the AIM Program has further diversified the portfolio and provided exposure to a variety of new perspectives and opportunities.

In addition, the AIM Program has increased staff to both better monitor the complex portfolio and bring work previously performed by consultants in-house. The reduced administrative burden provides staff with more time to focus on the investment of the portfolio and new investment opportunities. This effectively reduces costs while allowing staff to develop skills and competencies crucial to long-term and sustainable investment returns.

Implementation of Asset Allocation Rebalancing Accounts

The Asset Allocation program has implemented a Rebalancing Account that has been used to reduce risk and enhance investment performance. Designed to correct deviations from asset allocation policy targets, the Rebalancing Account also allows the Asset Allocation staff to overweight or underweight certain asset classes when the associated risk justifies such a position. With the Rebalancing Account, staff exercises discretion to more intelligently rebalance by incorporating market views and other criteria that cross asset classes.

Previously, the rebalancing function was located within each asset class. Moving this function to a central area simplifies the decision making process and allows for an easier accounting of performance.

The Rebalancing Account provides the Investment Office with a vital tool that adds value to investment performance and increases staff development by encouraging market assessments that cross asset classes. With this tool staff has the flexibility to manage the fund's asset allocation relative to its targets with precision and timeliness.

V. STRATEGIC PLAN:

The initiatives described in this item fit with the CalPERS Strategic Goal IX which sets out to achieve long term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The costs associated with this item are minimal as they are already absorbed by other ongoing CalPERS investment programs.

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